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SUBJECT: LEBANON: ECONOMY MINISTERS UPBEAT ON FINANCES,
DOWNBEAT ON MARCH 14 AND CBL OBSTRUCTION OF PRIVATIZATION

Classified By: Ambassador Jeffrey D. Feltman for reasons 1.4 (b) and (d).

SUMMARY

1. (C) Ministers Azour and Haddad met the Ambassador on June 1 ahead of a ministerial meeting scheduled to give political affirmation to the LAF's military operations in Nahr al-Barid. Haddad described his determination to use economic policy to address extremism. Azour reassured us that the GOL is meeting all EPCA benchmarks and the Lebanese economy is on track to grow 2-3 percent this year if the security situation does not deteriorate. Azour expressed confidence that higher revenues, international aid, limited additional borrowing, and adequate GOL planning will prevent a financial crunch this year. However, Azour and Haddad were exasperated by March 14 allies and CBL Governor Salameh's obstruction of their privatization program. They worried that they will not be able to set the reform program fully in motion before a change in government. End Summary.

MINISTERIAL MEETING TO
BLESS LAF OPERATIONS

2. (C) Minister of Finance Jihad Azour and Minister of Economy and Trade Sami Haddad met the Ambassador and Econoff on June 1 in a Grand Serail guarded by the Internal Security Forces (ISF), while the Lebanese Armed Forces (LAF) began their assault on Fatah al-Islam in the Nahr al-Barid refugee camp. Haddad noted that the ministerial meeting scheduled for later that day would signal a political blessing for the LAF to continue and expand its military operations. (Note: Haddad explained that the meeting would be "ministerial" rather than a formal cabinet meeting, because the absence of traveling ministers would preclude a quorum and because the meeting agenda was not delivered to President Lahoud 48 hours in advance. End Note.)

3. (C) Haddad expressed frustration with Saad Hariri's post-tribunal-passage television appearance, in which Saad emphasized the army's political independence and unwittingly highlighted the government's lack of control over the military. Why should a government ask the public to support the army, or ask the army to remain neutral, when the army should be taking orders from the government, Haddad asked. In the same vein, Haddad reiterated his frustration that the government had not issued orders for the LAF to remove the opposition "tent city" from downtown because the GOL feared the army might not obey the order.

CURBING LEBANESE EXTREMISM
WITH SOCIAL PROGRAMS

14. (C) Haddad went on to describe his renewed determination to use economic policy to address the problem of Sunni extremism. There is no Palestinian dimension to Fatah al-Islam and the conflict in Nahr al-Barid, Haddad told us, because most Fatah al-Islam members arrested thus far have been Lebanese and Syrian. While the GOL must root out all extremists, it must also entice people away from Sunni extremism with more moderate religious influences and a strong social program that targets the disadvantaged. Haddad told us that he has been far more aggressive lately toward his colleagues in cabinet meetings, in particular urging Minister of Social Affairs Nayla Mouawad to stop making excuses and move quickly to start pilot programs to target the poorest citizens. International organizations are standing by ready to help Lebanon bring its embarrassingly low social indicators into line with its high per-capita spending, while Mouawad and others are dragging their heels. This inaction is unacceptable morally, let alone politically, Haddad told us.

DEFICIT UP, BUT
ECONOMIC INDICATORS STRONG

17. (C) Azour reassured us that the GOL is meeting quantitative and practical benchmarks laid out in the Early Post Conflict Agreement (EPCA) with the IMF. The GOL is addressing any problems it foresees well ahead of time, and does not anticipate a financial crunch this year. Economic projections for the EPCA were conservative, based on a modest

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1 percent growth; INSEE-supported Central Bank of Lebanon (CBL) economic data, trusted by the MOF, as well as leading indicators, lead Azour to believe that growth will reach 2-3 percent this year, if there is no further deterioration in the security situation. Exports have increased and real estate transactions remain strong, due to strong economic growth and demand in the region and the weakening of the LL against the Euro. Lebanon's incoming remittances rise during periods of political instability, Azour told us.

18. (C) Responding to our concern that a recent Ministry of Finance press release announced that the deficit increased in the first four months of the year from 17 to 27 percent of expenditures, Azour said that this was "not unexpected." He attributed the overall rise in expenditures to payments to EDL and a lump sum payment to the National Social Security Fund to settle arrears. (Note: The press release also attributed the rise to 16 percent higher debt service costs. End Note.)

19. (C) First quarter revenues increased compared to a strong 2006 due to a higher VAT, a higher tax on stable bank deposits, taxes on higher real estate prices, increased customs revenues as businesses restock their inventories, and on strong transfers from the state-owned telecom sector, port of Beirut, and the airport. In addition, Azour credited several tax administration reforms with improving collection.

110. (C) In addition, capital flows are stable, the interest rate is under control, and the government last week was able to raise \$400 million in new debt, largely from domestic rather than international investors. The GOL has not yet hit its parliamentary-imposed borrowing ceiling, and could borrow up to \$1 billion more this year if necessary.

PARIS III AID
STILL TRICKLING IN

¶11. (C) Finally, up to \$1.3 billion in expected inflows of Paris III budgetary support aid will further ease financial pressures this year. The IMF, in addition to delivering its \$77 million in aid when Lebanon signed the EPCA, is encouraging donors to provide budget support rather than project aid. The World Bank should deliver \$100 million in budget support in June, based on power sector benchmarks, and a second \$100 later in the year based on social sector programs. The Saudis have already delivered \$100 million and are discussing transforming some of their \$1 billion in proffered projects into cash aid. The United Arab Emirates rescheduled its \$300 million in aid to fit a Lebanese parliamentary requirement that debt repayment not exceed 15 years. France is expected to deliver its aid after its parliament convenes in July. Malaysia is negotiating a new, concessional budget support loan. The Arab Monetary Fund is still negotiating a \$350 million package.

¶12. (C) Finally, under the currently proposed terms Lebanon could receive up to \$175 million from the United States this year. In the final stages of negotiating the conditions for U.S. aid, Azour requested that we return to our originally proposed conditionality, focused on the lifting of gas subsidies and the solicitation of bids for the sale of the telecom licenses. Azour made this request because he thought it would enable the U.S. to disburse the money in September rather than in December.

MARCH 14 ALLIES
SLOWING PRIVATIZATION

¶13. (S) "We need the privatization train to leave the station before we have a new president and a new cabinet," Haddad warned us, implying that reform would be significantly harder under a new leadership team. Azour asked that the USG hold its March 14 allies to their own timetable for privatization; several of them are allowing personal interests to interfere with the cabinet-approved reform program. The GOL can continue reforms despite the political impasse, Azour emphasized, and in fact, the current government has a unique opportunity to make quick, coherent decisions because all those who really object have left. Clearly, it is individual March 14 ministers, then, who are the bottlenecks.

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¶14. ((S) Specifically, Azour and Haddad pointed to Minister of Telecommunications Marwan Hamadeh and Director General Abdel Menem Youssef as selfishly delaying the corporatization of fixed-line provider LibanTel and slowing progress toward the sale of the two mobile licenses. The mobile licenses could have been sold before the war, Haddad argued, if Hamadeh had not stood in the way. They pointed to Acting Minister of Energy and Water Safadi as hindering the corporatization of EDL and the authorization of an IFC program to facilitate creation of independent power producers to increase power generation. The Prime Minister, while a champion of reforms, is both distracted by other issues and does not have enough sway over Hamadeh and Safadi to change their behavior. Less urgently, Haddad cited Nayla Mouawad as dragging her heels on the social reform program.

CBL GOVERNOR SALAMEH
OBSTRUCTING PRIVATIZATION

¶15. (S) CBL Governor Riad Salameh is also resisting privatization and "acting in bad faith" by unilaterally delaying the sale of assets inappropriately held by the CBL, Azour and Haddad explained. Salameh several years ago used the IFC to help him restructure the Casino du Liban, but has to date refused to sell the politically sensitive and lucrative monopoly. While the Central Bank announced in May

that it would sell a 25 percent stake in Middle East Airlines later this year, Azour and Haddad argue that it should be sold now; if another war breaks out and MEA planes are hit, the CBL will have to use its assets to recapitalize the company, tying up already severely limited liquidity. Such assets cannot be used in monetary policy, the core mission of the CBL. The CBL balance sheet is already not as healthy as it should be.

¶16. (S) Finally, in outright criticism of Governor Salameh, Azour candidly assessed that CBL independence has moved well beyond the independence a healthy central bank needs. There are no legal checks on the CBL, he explained, as it does not need to report to the cabinet or parliament, and the IMF is the only pressure on the governor. The last time the CBL sold an asset, it was sold in a non-transparent fashion to Salameh's brother in law, Azour warned us.
FELTMAN